

Internal Revenue Service  
**memorandum**

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to: District Counsel, Hartford  
Attn: Andrew R. Ceccherini

CC:HAR

from: Director, Tax Litigation Division

CC:TL

subject:

[REDACTED]

Docket No. [REDACTED]  
Docket No. [REDACTED]  
Docket No. [REDACTED]  
Docket No. [REDACTED]

The following analysis responds to your request for technical advice dated July 24, 1987.

ISSUE

Whether a trust, formed to exploit an oil lease, should be classified as an association taxable as a corporation under I.R.C § 7701(a)(3)1/?

CONCLUSION

Because [REDACTED] has associates, a business objective, continuity of existence, free transferability of interests, and centralized management, the trust should be classified as an association under section 7701(a)(3).

FACTS

In [REDACTED], [REDACTED] individual grantors formed [REDACTED] under the laws of the State of Connecticut, contributing in the aggregate \$ [REDACTED] (\$ [REDACTED] each for [REDACTED] units) to the trust. The trustee, [REDACTED], paid the \$ [REDACTED] to [REDACTED] in exchange for an oil lease.

During [REDACTED], [REDACTED] wells were drilling on the subject lease at an alleged cost of \$ [REDACTED] or \$ [REDACTED] for each of the [REDACTED] units. No income was produced in connection with the subject lease in [REDACTED].

1/ Unless otherwise indicated, all section references are to the Internal Revenue Code in effect during the years at issue.

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## ANALYSIS

Section 7701(a)(3) provides, "The term 'corporation' includes associations, joint stock companies, and insurance companies." The Supreme Court fleshed out the meaning of section 7701(a)(3) in Morrissey v. Commissioner, 296 U.S. 344 (1935) and its companion cases, Swanson v. Commissioner, 296 U.S. 362 (1935), Helvering v. Combs, 296 U.S. 365 (1935), and Helvering v. Coleman-Gilbert, 296 U.S. 369 (1935). Treas. Reg. § 301.7701-1 through -4 reflect the Supreme Court's analysis and expand thereon.

An association is a type of unincorporated organization that is taxed as a corporation. If an organization has more corporate characteristics than non-corporate characteristics, it will be classified as an association taxable as a corporation for federal tax purposes, even if it is not incorporated under local law. Morrissey, *supra*; Treas. Reg. § 301.7701-2(a)(3). Corporations ordinarily have the following six characteristics:

1. associates;
2. an objective to carry on business and divide the gains therefrom;
3. continuity of life;
4. centralization of management;
5. liability for corporate debts limited to corporate property; and
6. free transferability of interests.

Treas. Reg. § 301.7701-2(a)(1)

To determine whether an organization more closely resembles a corporation than a trust or partnership, characteristics shared by both types of organizations must be ignored. Treas. Reg. § 301.7701-2(a)(3). Thus, since continuity of life, centralization of management, free transferability of interests, and limited liability are common to trusts and corporations, the determination of whether an organization which has these characteristics more closely resembles a corporation than a trust will

generally depend on whether the organization has associates and a business objective.<sup>2/</sup> Morrissey, *supra*; Treas. Reg. § 301.7701-2(a)(2). Since associates and a business objective are common to partnerships and corporations, the determination of whether an organization which has these characteristics more closely resembles a corporation than a partnership will depend on whether the organization has continuity of life, centralization of management, free transferability of interests and limited liability. Treas. Reg. § 301.7701-2(a)(2).

Again, organizations which federal tax law would classify as partnerships and corporations share the characteristics of associates and a business purpose. At least one of these two characteristics is absent in organizations which federal tax law would classify as a trust. Therefore, an organization which has associates and a business purpose will be taxable either as a partnership or as a corporation under federal tax law. To determine the proper federal tax classification of [REDACTED], we will first determine whether the organization has associates and a business purpose. If [REDACTED] does not possess both of these characteristics, then it is taxable as a trust. If, however, [REDACTED] possesses associates and a business purpose, then in order to determine whether the organization will be treated as a partnership or as a corporation, the Service examines the remaining four corporate characteristics (continuity of life, centralization of management, free transferability of interests and limited liability). See, [REDACTED], G.C.M. 33181, I-1560 (Feb. 4, 1966) (trust treated as partnership). If the organization possesses a majority of the remaining four characteristics, then it is taxable as a corporation. Treas. Reg. § 301.7701-2(a)(3).

#### 1. Associates

The beneficiaries of [REDACTED] voluntarily associated themselves by buying units of beneficial interest. Where trust beneficiaries do not freely associate together to form the trust (as in the case of the typical testamentary or inter vivos trust in which the beneficiaries are involuntarily associated together by the grantor), associate status within the scope of Morrissey and Treas. Reg. § 301.7701-2 depends on whether or not the beneficiaries' interests are freely transferable and whether the beneficiaries have any control over the trust's management. Where the interests of beneficiaries who have not voluntarily associated are not freely transferable and

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<sup>2/</sup> Treas. Reg. § 301.7701-4 states general considerations for determining whether a trust more closely resembles a trust or a corporation and refers to Treas. Reg. § 301.7701-2 for a determination of the question in any particular case.

where the beneficiaries have no control over the management of the trust, the beneficiaries are not associates. See, Estate of Bedell v. Commissioner, 86 T.C. 1207, 1219-1221 (1986), acq. in result 1987-24 I.R.B. 4 (where the beneficiaries acquired their interests by way of testamentary bequest, it was testator's intent that the interests not be assigned or transferred, and the beneficiaries as a class had no power to control trust operations); Elm Street Realty Trust v. Commissioner, 76 T.C. 803, 813-817 (1981), acq. 1981-2 C.B. 1 (where trust beneficiaries during the years at issue received their interests by gift, the interests were not freely transferable, and the beneficiaries could exert no significant influence over the trust's operations). Where, however, trust beneficiaries voluntarily associate to form the trust, the beneficiaries are associates. Morrissey, supra, at pp. 356-57. Thus, since the beneficiaries of [REDACTED] voluntarily associated themselves by buying units of beneficial interest, the beneficiaries are associates.

## 2. An Objective to Carry on Business and Divide the Gains Therefrom

Parts I and III of the [REDACTED] agreement apparently authorize the trust to engage in all activities necessary to exploit the oil lease commercially. A trust has a business objective where the trust instrument provides the authority to engage in business activity, regardless of whether or not the trust actually conducts business. Helvering v. Coleman-Gilbert Associates, 296 U.S. 369, 373-74 (1935); Rev. Rul. 75-258, 1975-2 C.B. 503. Thus, [REDACTED] has a business objective. The division of authority between the trustee and the operator in the [REDACTED] agreement has no effect on this analysis. Compare, Commissioner v. Chase National Bank of the City of New York, 122 F.2d 540 (2d Cir., 1941) (Trust instrument divided authority between depositor and trustee, with trustee receiving nominal powers and depositor operating investment trusts. Because trustee and depositor had no powers beyond those necessary to the preservation of the trusts' res, the trusts had no business purpose.) with Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941) (Trust instrument divided authority between depositor and trustee, with trustee receiving nominal powers and depositor operating investment trusts. Because depositor had discretionary power to vary investments, the trusts had a business purpose.) and Julian Well No. 1 Syndicate v. Commissioner, T.C.M. 1944-388 (Trust instrument divided authority initially between institutional trustee and operator, with institutional trustee receiving nominal powers and operator operating oil lease trusts. Later, three managing trustees succeeded to the operator's powers for the year in issue. Because operator had power to conduct

business operations, and managing trustees succeeded to this power, the trusts had a business purpose.).

Because [REDACTED] has associates and a business purpose, the organization is not taxable as a trust. To determine whether [REDACTED] is taxable as a corporation or whether, instead, it is taxable as a partnership, we must examine the remaining four corporate characteristics.

### 3. Continuity of Life

Part V of the [REDACTED] agreement directs that "this trust may be revoked by the consent of all of the beneficiaries hereunder and until such time shall remain in full force and effect as an irrevocable trust except as hereinafter provided." Part VI of the agreement contemplates that the trust shall remain in existence "for so long as oil is produced on the leasehold estate in commercial paying quantities." Treas. Reg. § 301.7701-2(b) provides in pertinent part:

(1) An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization....

(2) For purposes of this paragraph, dissolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law....

(3) ... [I]f the agreement expressly provides that the organization can be terminated by the will of any member, it is clear that the organization lacks continuity of life. However, if the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life.

No beneficiary, acting individually, may terminate [REDACTED] pursuant to the trust agreement. Thus, unless Connecticut law would allow a single beneficiary to terminate the

trust, [REDACTED] has continuity of life. We have found no Connecticut precedents which support the proposition that one of several beneficiaries, acting alone, may terminate a trust. See, Hills v. Travelers Bank and Trust Co., 125 Conn. 640, 7 A.2d 656 (1939) ("Termination is to be limited to cases where not only all the interests created have vested and the parties are sui juris and represented but also the design and object of the trust has been at least practically accomplished."); Gaess v. Gaess, 132 Conn. 96, 42 A.2d 796, 799-800 (1945) (Trust does not fail by death of one beneficiary. Majority vote needed to terminate trust.). Therefore, [REDACTED] has continuity of life.<sup>3/</sup>

#### 4. Centralization of Management

The [REDACTED] agreement reposes managerial authority in the operator. (Agreement, Part II) The agreement gives the beneficiaries the right at any time to remove the operator by vote of two-thirds of the beneficial interest and to designate a replacement operator by vote of the majority of the beneficial interests. (Agreement, Part I) Treas. Reg. § 301.7701-2(c) provides in pertinent part:

Centralization of Management. (1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed....

(2) The persons who have such authority may, or may not, be members of the organization and may hold office as a result of a selection by the members from time to time, or may be self-perpetuating in office....

(3) Centralized management means a concentration of continuing exclusive authority to

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<sup>3/</sup> See, 16A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8266 (rev. vol. 1979) ("In a proper case and where the circumstances warrant it, a court may decree the dissolution of a business trust on behalf of the members, as where the consideration on which the trust agreement was executed fails; [footnote deleted] but dissolution and winding up will not be decreed where it is directly opposed to the plain terms and purposes of the trust agreement and there is no showing that the business can not be successfully continued as by a change in trustees.")

make independent business decisions on behalf of the organization which do not require ratification by members of such organization.

Thus, since the operator of [REDACTED] is "empowered to conduct all ... operations ... and shall have all authority to conduct such operations ... within his sole judgment and discretion..." (Agreement, Part II, 1(A)), [REDACTED] has centralized management.

## 5. Limited Liability

The [REDACTED] agreement is silent on the question of limiting the beneficiaries' liability for trust debts to the trust res.<sup>4/</sup> We have found no Connecticut precedents which shed light on the subject of limited liability for trust beneficiaries. 16a W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS (rev. vol. 1979) discusses the liability of business trust beneficiaries at § 8261. To ascertain whether or not beneficiaries of a business trust have limited liability, FLETCHER tells us to first determine "the legal nature or status of the relation created by the trust agreement, that is, whether it is a true trust or a partnership..." *Id.* The determination of "the legal nature or status of the relation created by the trust agreement" in turn depends on whether the trust articles vest the power of control in the trustees (organization treated as a trust under state law) or whether, instead, the trust articles place the power of control, either directly or indirectly, in the shareholders (organization treated as a partnership under state law). *Id.* at § 8230. Cases which FLETCHER cites to illustrate the preceding textual assertion indicate that where the trust agreement provides the beneficiary with the power to remove and replace the trustee, the organization is a partnership under state law. Since the [REDACTED] agreement provides trust beneficiaries with the power to remove the operator and to designate a replacement operator, available state law precedent would generally treat [REDACTED] as a partnership.<sup>5/</sup> Where "the trust agreement creates a partnership, the rights and obligations of the members as shareholders are those defined by the established rules of law applicable to ordinary partnerships [footnote omitted], and the members of the

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<sup>4/</sup> Part II, 1(B) of the agreement directs the operator to maintain liability insurance in amounts satisfactory for the protection of the beneficiaries. Thus, the agreement appears to contemplate that the beneficiaries will be personally liable for injury to person or property committed by the trust.

<sup>5/</sup> 16a W. FLETCHER, *supra*, at §§ 8230 and 8261, cites no Connecticut cases.

members of the association are liable for its debts as in the case of partners generally. [footnote omitted]" *Id.* at § 8261. Thus, following the analysis contained in 16a W. FLETCHER, beneficiaries of [REDACTED] appear to be personally liable for trust debts. Since [REDACTED] has continuity of life, centralization of management and, as discussed below, free transferability of interests, the absence of limited liability for trust debts is insignificant.

#### 6. Free Transferability of Interests

The [REDACTED] agreement gives the beneficiaries "the absolute right to assign their interests," but prohibits the beneficiaries from making a partial assignment without the consent of the grantor.<sup>6/</sup> (Agreement, Part II, 1(G)) Treas. Reg. § 301.7701-2(e) provides in pertinent part:

Free Transferability of Interests. (1) An organization has the corporate characteristics of free transferability of interests if each of its members or those members owning substantially all of the interest in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization.

Each beneficiary of [REDACTED] may confer upon his/her transferee all the attributes of his/her interest in the organization, without first obtaining the consent of anyone else. Thus, beneficiaries of [REDACTED] have freely transferable interests.<sup>7/</sup> Treas. Reg. § 301.7701-2(e). Connecticut precedents shed no light on this subject.

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<sup>6/</sup> The grantor appears to be the operator. (Agreement, Part I, 3(b)) There is an ambiguity on the face of the agreement, however, since the preamble and Part I, 1(A) refer to multiple grantors, and Part I, 1(B), (C) and (D) refer to a single grantor.


<sup>7/</sup> See, 16A W. FLETCHER, *supra*, at § 8243 (It is the general rule that business trust shares are transferable).



In conclusion, since [REDACTED] has associates, a business purpose, continuity of existence, centralization of management and free transferability of interests, it is an association under section 7701(a)(3). Note that the only substantive difference between [REDACTED] and the oil lease trust in Helvering v. Combs, 296 F.2d 365 (1935), is that [REDACTED] does not offer its beneficiaries limited liability.<sup>8/</sup> Since, under Morrissey and Treas. Reg. § 301.7701-2, an organization will be taxed as a corporation if it has more corporate than non-corporate characteristics, the absence of limited liability in the [REDACTED] agreement is not an important distinction.

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<sup>8/</sup> Cases involving the federal tax classification of oil lease trusts as associations are too numerous to list, and any discussion here would be repetitious. See, e.g., Adkins Properties v. Commissioner, 143 F.2d 380 (5th Cir. 1944); Commissioner v. Nebo Oil Co. Trust, 126 F.2d 148 (10th Cir. 1942), cert. den., 317 U.S. 636 (1942); Keating-Snyder Trust v. Commissioner, 126 F.2d 860 (5th Cir. 1942).